

OBBBA and the QBI Deduction

Take-Away: Modest changes were made to the qualified business income (QBI) income tax deduction for pass-through entities, which expands the number of business owners who may qualify for the deduction.

Background: The 2017 Tax Act created a new income tax deduction for the owners of pass-through active business entities, allowing eligible owners to deduct up to 20% of their *qualified business income* (QBI) to reduce the business owner's taxable income. However, not all owners of pass-through business entities could claim the income tax deduction. The 2017 Tax Act imposed two limitations on QBI, and thus the tax deduction.

Wage Limitation and UBIA: The first limitation, called the **wage limitation**, limits the deduction to the *greater* of (i) 50% of W-2 wages with respect to the qualified trade or business or (ii) the sum of 25% of wages with respect to the business, *plus* 25% of the **unadjusted basis immediately after acquisition** (or its acronym UBIA.)

SSTB: The second limitation is the **Specified Service Trade or Business** (or SSTB.) In effect, the pass-through business owner cannot take a QBI deduction if he or she is in one of the specified service trades or businesses, like health, law, accounting. This list of excluded service businesses is culled from IRC 1202, i.e., the qualified small business stock rules. While IRC 1202 excludes engineers and architects from its gain exclusion, the 2017 Tax Act, i.e., IRC 199A, does not exclude those two professions, and therefore they can claim the IRC 199A deduction. [Engineers and architects must have had a strong Washington lobby back in 2017.]

Protected Threshold Incomes: The wage limitation and the SSTB disallowance do *not* apply if the taxable income of the pass-through business entity is below certain thresholds. The initial income threshold was \$315,000 for married filing jointly taxpayers and \$157,500 for single taxpayers. Those amounts are indexed for inflation, so that in 2025 the threshold income amounts are \$394,600 (married) and \$197,300 (single.) Any income amount below that threshold amount enables the business owner to claim the full IRC 199A deduction without either the wage limitation or the SSTB disallowance.

Income Phase-in's: The 2017 Tax Act also added an income phase-in provision. An example hopefully explains how this phase-in works.

Example: For married individuals filing jointly, that initial phase-in was \$100,000. In other words, if an owner's income is below \$394,600 in 2025, he or she would receive the full IRC 199A tax deduction. If the owner's income was between \$394,600 and \$494,600 for married, filing jointly, then the owner will have the wage limitation and SSTB disallowance phased-in. After the owner's income exceeds \$494,600 for married filing jointly, then those limitations and disallowance will apply with full force. For a single taxpayer's return for 2025 the income range for phase-in is \$197,300 to \$247,300.

Report too much income and the IRC 199A income tax deduction is phased-out completely.

OB3: The OB3 increased the income range where the IRC 199A income tax deduction can be claimed, starting in 2026. Instead of being the \$100,000 range for married filing jointly, it is now going to be \$150,000 for married filing jointly taxpayers. For single filers, the \$50,000 range is now going to be a \$75,000 range.

Example: Assume that the \$394,600 income amount for 2025 increases by inflation to \$400,000 in 2026. Thus, the income range for married filing jointly business owners to qualify to claim the deduction would be \$400,000 to \$550,000 compared to the 2025 range of \$394,600 to \$494,600. Consequently, a larger group of taxpayers who own pass-through business entities will be able to benefit from that expanded income range. As for other taxpayers, e.g., a single taxpayer, the range for 2026 would be about \$200,000 to \$275,000 (after indexed for inflation) compared to the 2025 range of \$197,300 to \$247,300. Thus, more business owners should be able to now claim some, or all, of the IRC 199A QBI deduction.

OB3 also introduces a new *floor* starting in 2026 . For the owner of a pass-through business entity with less than \$1,000 in qualified business income from an active trade or business in which he or she materially participates, he or she will receive a minimum \$400.00 QBI tax deduction (which amount is indexed to inflation.)

Conclusion: The OB3 ‘tinkered’ with the IRC 199A qualified business income tax deduction, essentially expanding the number of pass-through business owners who can qualify to claim some, or all, of the income tax deduction. Sadly, OB3 did not simplify the cumbersome phase-in rules or make the deduction available to all service providers as was hoped.

There were initially reports that the OB3 would make two other changes, but neither came to pass. The first reported change was that the deduction amount was going to be increased from 20% to 23%. That did not happen. Also, there is a deduction for pass-through entity tax on state income taxes where pass-through entities elect to pay it. There were reported threats when the OB3 was being discussed (primarily behind closed doors) to disallow that state income tax election for some businesses, e.g., attorneys and accountants, but that change also did not make its way into the final OB3.

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